[JOINT COMMITTEE PRINT]

DESCRIPTION OF PROPOSAL RELATING TO SPECIAL LIMITATIONS ON THE CARRYOVER OF NET OPERATING LOSSES AND OTHER TAX ATTRIBUTES OF CORPORATIONS

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON
SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS

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CONTENTS

	Page
INTRODUCTION	1
I. SUMMARY	2
II. BACKGROUND	3
A. Overview	3
B. Statutory provisions related to NOL carryovers	3
C. Present law special limitations	5
III. ECONOMIC ISSUES	9
A. Overview	9
B. Refundability vs. limited recoupment	10
C. Options for change	13
IV. EVALUATION OF PRESENT LAW AND ALTERNATIVE APPROACHES	15
A. Problems with the rules adopted under present and prior law	15
B. Purpose of limitations	17
C. Purchase price limitations proposals	18
D. The ALI proposal	19
V. EXPLANATION OF PROPOSAL	21
A. Overview	21
B. The purchase rule	21
C. The merger rule	25
D. General rules	29
E. Passive assets	29
F. Effective date	30

INTRODUCTION

The Subcommittee on Select Revenue Measures of the Committee on Ways and Means has scheduled a public hearing on September 22, 1983, on a proposal relating to special limitations on the carryover of net operating losses (NOLS) and other tax attributes of corporations. This pamphlet, prepared in connection with the hearing, provides a description of the proposal, present law, and related issues.

The first part of the pamphlet contains a summary of the background of the proposal and of the proposal. The second part is a more detailed description of the background relating to the proposal, including present law. Part three is a discussion of economic issues relating to the carryover of tax attributes. Part four is an evaluation of present law and alternative approaches, and part five is a description of the proposal.

I. SUMMARY

Background

In general, a corporate taxpayer is permitted to carry a net operating loss ("NOL") forward for use against future income. The tax attributes (including NOLs) of one corporation can also be carried over to another corporation as the result of certain tax-free acquisitions. However, historically, the carryover of tax attributes has been subject to special limitations.

Under present law, the application of special limitations turns in part on specified changes in ownership in an acquired corporation. Present law has been criticized as being complex and ineffective. The Tax Reform Act of 1976 amended the present-law special limitations; however, the effective dates of these amendments have been delayed. Thus, the law in effect prior to the 1976 Act amendment continues to govern.

Description of the proposal

As under present law, the proposal would deal separately with two kinds of cases: those in which the loss corporation continues in existence but a majority of its stock is sold or exchanged (including in a redemption) following the loss year; and those in which the loss corporation is merged into another corporation in a transaction qualifying as a tax-free reorganization or in which ownership of the loss corporation changes as a result of new stock issues.

In situations where control of the loss corporation changes through sales or exchanges (or redemptions) of its stock but the loss company continues in existence without any infusion of capital, a "purchase rule" would apply to limit the amount of carried over tax benefits to an amount that approximates the amount that could have been used had no change of ownership occurred and had the loss company invested the assets it held at the time of the change of ownership in taxable assets. NOLs incurred by a corporation would be deductible as carryovers after a change in ownership only to the extent of a specified rate of return, reflecting an after-tax yield, on the price paid for the corporation's stock.

Where the loss corporation is a party to a merger, carryovers would be allowed to offset income produced by the contribution of the loss company to the capital of the combined enterprise. This approach is intended to provide for the allowability of carryovers roughly to the same extent they would have been allowable if the loss company and the other party to the merger had formed a partnership before the loss occurred. In that case, only the loss corporation's share of the income from the partnership could be offset by its carryovers.

II. BACKGROUND

A. Overview

Traditionally, a corporate taxpayer has been permitted to carry NOLs forward for use against future income, so long as the corporation's identity is maintained. Statutory rules also provide for the carryover of tax attributes (including NOLs) from one corporation to another in certain tax-free acquisitions. Historically, however, the carryover of tax attributes has been subject to special limitations.

Under present law, the application of special limitations on NOL carryovers turns, in part, on specified changes in stock ownership of the corporation that suffered the NOL. For purchases (and other taxable acquisitions) of stock, special limitations come into play if there is a 50-percent ownership change *and* the loss corporation fails to continue an historical trade or business. In the case of a reorganization, special limitations apply only if the shareholders of the loss corporation end up owning less than 20 percent of the successor corporation. The special limitations applicable to NOL carryovers in reorganizations also apply to other tax attributes.

The Tax Reform Act of 1976 amended the present-law provisions for special limitations, in order to coordinate the rules for purchases and reorganizations and to close loopholes. However, the 1976 Act amendments have been criticized, and, as a consequence, the effective dates of these amendments have been repeatedly delayed.

B. Statutory Provisions Related to NOL Carryovers

Net operating loss deduction

Although the Federal income tax system generally requires an annual accounting, taxpayers are permitted to carry NOLs forward for use against future income (sec. 172). The rationale for the allowance of a NOL deduction is that a taxpayer should be able to average income and losses from a trade or business over a period of years, in order to reduce the disparity in the tax treatment of businesses that experience fluctuations in income as compared with businesses that have stable incomes. This rationale is particularly persuasive in view of the existence of tax provisions that deliberately mismatch income and related expenses in order to provide investment incentives (*e.g.*, the accelerated cost recovery system and the intangible drilling costs provisions).

In general, after giving effect to a 3-year carryback period, a corporate taxpayer is allowed to carry NOLs forward to each of the 15 taxable years following the year of loss. Any portion of the loss remaining after the termination of the 15-year carryforward period expires.

Carryovers to successor corporations

In general, the tax attributes of a corporation (including NOLs) are preserved only by continuing the corporation's identity. However, statutory rules provide for the carryover of tax attributes from one corporation to another in certain tax-free reorganizations and in the case of the tax-free liquidation of an 80-percent owned subsidiary (sec. 381(a)). These statutory rules are applicable if assets of a loss corporation are acquired by another corporation in one of the following transactions:

(1) the liquidation of an 80-percent owned subsidiary (to which sec. 332 applies);

(2) a statutory merger or consolidation (sec. 368(a)(1)(A));

(3) the acquisition of substantially all of the assets of one corporation for voting stock of another corporation (sec. 368(a)(1)(C);

(4) the transfer of substantially all of a corporation's assets to a controlled corporation, followed by the complete liquidation of the transferor (secs. 368(a)(1)(D) and 354(b)(1));

(5) a mere change in identity, form, or place of organization of a corporation (sec. 368(a)(1)(F); and

(6) a tax-free bankruptcy reorganization (secs. 368(a)(1)(G) and 354(b)(1)).

In addition to NOL carryovers, other tax attributes that carry over from one corporation to another include: unused investment credits that can be carried forward under section 46(b); unused foreign tax credits that can be carried forward under section 904(d); and net capital losses that can otherwise be carried forward under section 1212.

Acquisitions to evade or avoid tax

The Secretary of the Treasury is authorized to disallow any deduction (including a NOL deduction) when tax avoidance is the principal purpose for the acquisition of control of a corporation or for certain transfers of property from one corporation to another (sec. 269). This provision applies in the following cases:

(1) where any person or persons acquire at least 50 percent of a corporation's voting stock or stock representing 50 percent of the value of the corporation's outstanding stock (regardless of whether such stock is acquired by purchase or in a tax-free transaction); or

(2) where a corporation acquires property of another previously unrelated corporation, and the acquiring corporation's basis for the property is determined by reference to the transferor corporation's basis.

The Libson Shops doctrine

In *Libson Shops, Inc.* v. *Koehler*, 353 U.S. 382 (1957), a case decided under the 1939 Code, the United States Supreme Court adopted a test of business continuity for use in determining the availability of NOL carryovers. *Libson Shops* involved a merger of sixteen commonly owned corporations into one corporation. The corporation representing the combined enterprises then sought to utilize the pre-merger NOLs of three of the merged corporations against the

post-merger income of the other thirteen operations. The NOL carryover was denied on the ground that the income against which the deduction was claimed was not produced by the same businesses that incurred the loss.

There is uncertainty as to whether the *Libson Shops* doctrine has any continuing vitality as a separate nonstatutory test for determining the availability of NOL carryovers in any situation.

C. Present Law Special Limitations

Present law provides radically different rules for the application of special limitations on carryover attributes after a purchase (or other taxable acquisition) of stock and after a tax-free reorganization (sec. 382).

Taxable purchases

The rule for purchases applies if one or more of the ten largest shareholders increase their common stock ownership, within a two-year period, by 50 percentage points or more (except where the stock is acquired from a related person) (sec. 382(a)). If the purchase rule applies, the corporation's NOL carryovers are allowed in full if the corporation continues to conduct a prior trade or business or substantially the same kind of business, unless tax avoidance was the principal purpose for the stock purchase. However, if a historical business of the corporation is not continued, NOLs are completely lost.

Under the purchase rule, a 100-percent change in ownership does not result in the disallowance of NOLs even if a new profitable business is added to absorb NOLs incurred by the former owners, so long as the old business is continued and section 269 is not applicable. Further, an acquisition of control of a loss corporation through the issuance of new stock does not constitute a purchase under present law and therefore avoids the special limitations.

Tax-free reorganizations

In the case of a tax-free reorganization, the special limitations apply only if there is an 80-percent change in the ownership of the loss corporation (sec. 382(b)). Thus, assuming section 269 is not applicable, NOL carryovers are allowed in full if former owners of the loss corporation receive stock representing 20 percent or more of the value of the acquiring corporation (not counting preferred stock). For each percentage point less than 20 percent received by the loss corporation shareholders, the NOL carryover is reduced by five percent. Under section 382(b), it is immaterial whether the business of the loss corporation is continued after a reorganization.

The reorganization rule can be circumvented by using a subsidiary to acquire the loss corporation's assets in exchange for stock of a parent corporation, since the 20-percent test is applied by treating the loss corporation shareholders as receiving stock in the subsidiary equivalent in value to the stock they receive in the parent corporation. Full preservation of NOL carryovers can also be obtained by issuing participating or voting preferred stock to the shareholders of a loss corporation, so long as the value of the stock is at least 20 percent of the value of the acquiring corporation's

stock. Further, tax-free stock-for-stock acquisitions (under sec. 368(a)(1)(B)) are outside both the reorganization rule and the purchase rule.

Effect of section 269 and the Libson Shops doctrine

Present law injects an element of uncertainty into acquisitive transactions because NOL carryovers are subject to disallowance under the provision relating to acquisitions made to evade or avoid taxes and, to a lesser extent, under the *Libson Shops* doctrine, even if the special limitations are avoided. Commentators have argued that the effect of this uncertainty is that the price payable for a loss corporation is discounted to take account of the possibility that the NOL carryover will be reduced, or wholly disallowed, resulting in a windfall to the acquirer if the NOLs are ultimately allowed.

Consolidated return regulations

The consolidated return regulations impose additional limitations on NOLs. For example, if more than 50 percent of the fair market value of the stock of the common parent of an affiliated group changes hands by purchase, NOLs of members of that group may be carried over only against subsequent income of those members. (Treas. Regs. sec. 1.1502-21(d).) This is the consolidated return change of ownership ("CRCO") rule.

In addition, if the stock of a loss corporation is acquired by a member of an affiliated group filing consolidated returns, NOLs of that corporation may be carried over only against subsequent income of that corporation, not income of other group members. (Treas. Regs. sec. 1.1502-21(c).) This is the separate return limitation year ("SRLY") rule. Rules (the reverse acquisition rules) are also provided to assist in applying the SRLY rule. (Treas. Regs. sec. 1.1502-75(d)(3).)

Subject to whatever limitation section 269 may impose, these rules can be avoided by transferring profitable businesses or assets to the acquired corporation or corporations.

1976 Act amendments

The Tax Reform Act of 1976 extensively revised the statutory provisions for special limitations on NOL carryovers, providing more nearly parallel rules for taxable purchases and tax-free reorganizations. The 1976 Act amendments were to be effective generally in 1978. However, in response to wide criticism, the effective dates have been repeatedly delayed. The 1976 Act amendments to the purchase rule are scheduled to become effective for years beginning after June 30, 1984; the amended reorganization rules are scheduled to become effective for reorganizations pursuant to plans adopted on or after January 1, 1984. Until the 1976 Act amendments take effect, present law continues to govern.

In general.—As enacted, the 1976 Act eliminates the test of business continuity applicable under the purchase rule; thus, the 1976 Act amendments focus solely on changes in stock ownership. The point at which an acquisition brings the limitations into play was raised from 50 to more than 60 percentage points. Thus, for purposes of both the purchase rule and the reorganization rule, the loss corporation shareholders must retain a 40-percent continuing

interest in order for NOL carryovers to be allowed in full. For each percentage point (or fraction thereof) less than 40 percent but not less than 20 percent, the NOL carryover is reduced by 3½ percentage points. For each percentage point (or fraction thereof) less than 20 percent, the NOL carryover is reduced by 1½ percentage points. Thus, a 100-percent change in ownership results in total disallowance of loss attributes whether or not the historic business is continued.

The 1976 Act also introduced the concept of "participating stock" (i.e., stock that represents an interest in the corporation's growth potential) into the law, in order to prevent acquiring corporations from using certain preferred stock to circumvent the rules for determining whether a change in ownership has occurred. Under the amendments, the lesser of the participating stock or the percentage of all stock is taken into account in determining the extent of the loss corporation shareholders' continuing interests.

The 1976 Act did not repeal the provision (sec. 269) relating to acquisitions for tax avoidance purposes.

Taxable purchases.—The 1976 Act amendments expanded the category of transactions that are treated under the purchase rule to include capital contributions that increase a shareholder's percentage ownership. The shareholders taken into account under the 1976 amendments are those who hold the 15 largest percentages of the total value of the corporation's stock on the last day of its taxable year. The relevant points for determining the extent of any ownership change as of the end of any taxable year are to be the beginning of the year under examination and the beginning of the first and second preceding taxable years.

Tax-free reorganizations.—Under the 1976 Act amendments, stock-for-stock acquisitions (under sec. 368(a)(1)(B)) are made subject to the reorganization rule.

In order to discourage the owners of a profitable corporation from artificially satisfying the continuity rules by buying stock in a loss corporation and then merging with it within a short period of time, a 3-year rule disqualifies certain owners of a loss corporation from being included in the continuity test. This rule applies to stock acquired in the loss corporation within 36 months before the reorganization by the other party to the reorganization, or by one or more shareholders who own more than 50 percent of the fair market value of the stock of such party, or by a controlled subsidiary of such other party. Any such stock must be disregarded in measuring continuity.

A separate rule covers a situation where a holding corporation (or an operating corporation) which controls a loss corporation merges or otherwise reorganizes with a profitable corporation (regardless of which corporation acquires the other). The 1976 Act requires, in effect, that the stock which the holding corporation's shareholders receive (or retain) will determine how much of the actual loss corporation's carryovers survive the reorganization.

Special limitations on other tax attributes.—Section 383 incorporates by reference the same limitations as those contained in section 382 for application to tax attributes other than NOLs, including investment credits, foreign tax credits, and net capital

losses. The Tax Reform Act of 1976 also amended section 383 to adopt the same amendments as those made to section 382.

III. ECONOMIC ISSUES

A. Overview

Under current law, a net operating loss (NOL) may be carried back 3, and carried forward 15, tax years (sec. 172). In the case of carrybacks, the taxpayer is entitled to a refund equal to the reduction in tax liability in the 3 prior years which results from taking account of the NOL in those years. If the NOL exceeds the sum of the taxable incomes in the preceding 3 years, the taxpayer may deduct the unused NOL from taxable income in the 15 succeeding years. (Somewhat similar rules apply to certain unutilized tax credits related to business activity, such as the investment credit.)

Since loss recoupment is limited by tax liability on past and future income, there is an incentive for loss companies to increase their taxable income or combine with profitable companies in order to accelerate the rate at which loss and credit carryovers can be utilized. Code sections 269, 381, and 382, among other tax provisions, restrict loss recoupment in certain situations in which corporate ownership changes. These provisions have been the source of a prolonged controversy between those advocating unrestricted sale of loss corporations ("free trafficking") and those favoring anti-trafficking rules.

The economic arguments have focused on the question of whether a system which refunds the tax on losses ("refundability") is in principle preferable to the current system of limited recoupment. Supporters of the refundability concept favor either outright payments of refunds by the Treasury to taxpayers with NOLs or free trafficking in losses. The free trafficking approach relies on an acquiring corporation to act as a tax intermediary, passing through the benefit of more rapid recoupment, in the form of a larger acquisition price, to the loss company's shareholders.

In the next section, the merits and demerits of the refundability concept are examined. In comparing refundability with limited recoupment, many issues arise. Of particular concern is the comparative efficiency of these two systems. Efficiency would require that acquisition and reorganization decisions not be influenced by the tax system. Another issue is the interaction between loss recoupment and other mechanisms for tax benefit transfers, such as leasing and special allocations within partnerships. Other issues include the revenue cost, equity, and public perception of refundability. As indicated below, neither the refundability nor partial recoupment approach is entirely satisfactory from the standpoint of equity or efficiency.

There are two primary directions for changing the treatment of losses under current law. One general approach would be to allow free trafficking in loss carryovers, similar to the safe-harbor leasing provisions adopted in 1981 (and repealed in 1982). The second

25-032 O - 83 - 2

approach would be to reformulate limitations so that the effects of a change in corporate ownership would be comparable to the results which would obtain under a related set of facts. For example, one possibility would be to consider that a purchase of a loss corporation's stock should result in allowing a benefit from NOLs equivalent to that which would have been allowed if the loss corporation's assets had been acquired, so that a purchaser of all of a loss corporation's stock could get no benefit from these losses. Another possibility would be to allow the purchasing corporation to benefit from the losses to approximately the same extent that the loss corporation would have benefited had it remained independent. The latter option, which would, in effect, allow the loss corporation to sell a limited amount of its losses to the purchaser, has been developed by the American Law Institute (ALI) and is the basis for the proposal presented in part V of this pamphlet.

B. Refundability vs. Limited Recoupment

In a pure refundability system, a taxpayer with an NOL would get a refund equal to the tax savings which would have been realized had the taxpayer been able to use the NOL in the current tax year.[1] In the absence of a merger or acquisition, the value to a loss company of its unutilized NOL carryovers may be less under current law than in a refundable system. This occurs most clearly when the NOL is extinguished because it cannot be used within the 15-year carryover period or because the loss company goes out of business. Even if the NOL is eventually utilized within the 15-year carryforward period, however, its value will be less than under a refundable system because of the time value of money (i.e., the present value of the NOL deduction is lower). As a result, under present law, the value of loss carryovers varies among companies depending on their past and future income.

Arguments in favor of refundability

Advocates of refundability argue that it is more efficient and equitable than present law. They view current law as particularly unfair to start-up and undiversified companies. A start-up company is unable to get any immediate benefit from NOLs because it has no prior-year income. As an example, consider an investment project which throws off a loss of $10 in the first year and a profit of $20 in the second year. Assuming a 50-percent tax rate, a loss company undertaking this project would have no tax in the first year and a $5 tax in the second year. An ongoing company undertaking this investment would realize a $5 tax reduction in the first year and pay $10 of tax in the second year. The cumulative tax liability over the two-year life of the investment is $5 for both taxpayers; however, the present value of the tax loss is greater for the ongoing company than the start-up company. Only if the start-up company diversifies (by investing in assets which generate taxable income sufficient to utilize its losses) will it be able to compete on a level playing field.

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[1] With graduated rates, however, the tax rate at which to compute the taxpayer's refund would be ambiguous (possibilities include the top rate, the bottom rate, or graduated rates).

In general, under current law, any investment for which there is some probability of loss is more attractive to a diversified than a specialized company. This is the case because a diversified company has a more stable income stream, and consequently, a higher probability of utilizing tax deductions in the year they arise. Thus, the present system provides a tax incentive for firms to diversify and merge into other lines of business, even where conglomerate organization may be less efficient.

Further, the present system of partial recoupment encourages various types of otherwise non-economic financial arrangements in order to obtain or accelerate the utilization of loss carryovers. Firms with large loss and credit carryovers can increase their net worth by executing a properly structured merger, partnership agreement, or takeover deal with a company possessing substantial taxable income. Code sections 269, 381, and 382, and other provisions, limit, but do not eliminate, loss trafficking. Indeed, these provisions may encourage the operation of unprofitable assets, following acquisition, to preserve the right to utilize acquired carryovers. Further, these anti-trafficking provisions do not prevent a company with an NOL from acquiring assets whose income can be sheltered by the carryover.[2] If a company has (or anticipates having) an NOL, then there is an incentive to lease as opposed to own assets, because the company itself may be unable to obtain the full benefit of depreciation deductions and the investment credit.[3] All of these transactions, to the extent they are tax-motivated, may tend to reduce economic growth since the efforts of lawyers, bankers, and businessmen, among others, are devoted to asset-rearranging, rather than asset-increasing, activities.

Under current law, the government taxes any profits thrown-off by an investment, but does not necessarily share equally in any losses. Thus, relative to a refundable income tax, imposed at the *same* rate, there may be less risk-taking.[4] This may reduce innovation and hurt the ability of the U.S. economy to compete worldwide in the high technology market.

Arguments against refundability

A refundable income tax system, with the *same* tax rate as present law, would tend to increase risk-taking; however, this additional risk-taking is not unequivocally beneficial to society. Economic analysis shows that a refundable income tax system may increase risky investments beyond the level which would exist in the absence of the tax.[5] This can occur because refundability would

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[2] For example, Fedders Corporation plans to restructure its assets in order to use its NOLs. "Concerning the divestiture of our central air conditioning businesses, we are encouraged by the interest shown by potential purchasers. These businesses, together with our real estate being offered for sale, should generate in excess of $60,000,000 in cash that can be used for working capital, expansion of our continuing businesses or acquisitions that would utilize our substantial loss carryforward which presently amounts to approximately $120,000,000 or about $10 per share." (Fedders Corporation, "Highlights of the Annual Meeting of Stockholders, June 30, 1983.")

[3] Repeal of the "safe-harbor" leasing provisions in 1982 restricted tax benefit transfers; however, conventional and "finance" leasing can also be used to achieve similar results. For a discussion of issues related to leasing, see "Analysis of Safe Harbor Leasing," a report by the staff of the Joint Committee on Taxation, June 14, 1982 (JCS-23-82).

[4] A.B. Atkinson and J.E. Stiglitz. *Lectures on Public Economics*. pp. 112-115.

[5] A.B. Atkinson and J.E. Stiglitz, p. 107.

provide insurance against losses, thus reducing the variance of after-tax returns and making risky investments more attractive to certain investors. Also it is not clear that present law significantly limits total risk-taking since companies with large amounts of historic taxable income are effectively able to refund losses using the 3-year carryback rule. Consequently, there may only be a shift in the ownership of risky investments (to large and diversified companies and away from small and undiversified companies), rather than a reduction in the volume of these investments.[6]

Critics of refundability also argue that this proposal would not be perceived as more equitable than the current system of partial recoupment. After the enactment in 1981 of the safe-harbor leasing provisions, which moved the tax system closer to refundability, there was a widespread public perception that these provisions were unfair. Ultimately, these sentiments played a role in Congress' decision to phase-out safe-harbor leasing in 1982. Similar perception problems might arise with the adoption of refundability. Companies which have lost hundreds of millions of dollars would receive refund checks from the Treasury for the amounts lost without any government conditions on investment or employment decisions. Where management incompetence was perceived to be the cause of these losses, taxpayers would likely resent the huge payments required by refundability. Individuals, including unincorporated businesses, could believe that it was unjustified to have such a system for corporations without having, in effect, a similar negative income tax system for individuals. Taxpayer compliance could decline as a result of these perceptions of unfairness.

Opponents of refundability also argue that it would have a sizable revenue cost and, thus, that it would not necessarily be more efficient than the current tax system. If refundability were adopted on a prospective basis, there would be a substantial revenue cost. To prevent an increase in the deficit, this revenue loss would have to be made up by raising the rate of the corporate income tax or increasing other taxes. Each of these options may reduce economic efficiency by more than the gain from refundability.

Under present law, the revenue cost and economic impact of the numerous deductions and credits in the Code are limited by taxpayers' abilities to generate positive taxable income without running afoul of the various anti-trafficking rules. In a system of complete refundability, no such limitation would exist. This is a very important problem with the refundability concept since many of the current tax provisions have been criticized as preferences which distort economic activity. Without a substantial reduction in allowable deductions and credits, refundability could increase both the revenue loss and economic misallocations caused by these provisions.

Because a portion of all business tax deductions would automatically be offset by the Treasury, refundability could also increase the incentive to exaggerate wage and interest expense, to accrue paper losses, and to incur deductions in pursuit of businesses which are disguised hobbies. Obviously, these problems exist under cur-

[6] This shift in the ownership and control of risky investment projects may be cause for concern if large companies are intrinsically less innovative than small or start-up companies.

rent law, and there are Code sections which deal with them.[7] Nevertheless, refundability could place substantially more pressure on these rules and increase the costs of monitoring and enforcement.

A final argument made against refundability is that, due to graduated tax rates, the bias against start-up and undiversified companies would not be eliminated by refundability. Under both present law and refundability, for example, a $100,000 loss on an investment reduces the tax liability of a company with $200,000 of taxable income more than a company with only $100,000 of taxable income ($46,000 vs. $26,750). Clearly, any graduated rate income tax is nonneutral in this sense. To achieve a completely neutral tax system (a goal advocated by proponents of refundability) would require a flat-rate income tax, which many taxpayers may perceive as inequitable.

C. Options for Change

Two major options for changing the present loss carryover rules have received considerable attention: refundability and rationalized anti-trafficking rules. The pros and cons of both approaches are discussed below.

Refundability

Refundability may appeal to those who believe that there are significant advantages in more nearly equalizing the benefit which different taxpayers receive from available deductions and credits. One way in which this objective may be partially accomplised would be to eliminate the anti-trafficking rules (primarily secs. 269, 381, and 382). However, this option is inferior to a pure refundability approach in several respects. First, in an acquisition, the loss company's shareholders would typically end up sharing a portion of the value of their tax losses with the acquiring company's shareholders. This sharing would be arbitrary, since the value of the loss company's shares would depend on a potential buyer's ability to use the tax benefits. Second, free trafficking would encourage the churning of assets through mergers, acquisitions, and partnerships which have no economic rationale other than tax savings.

An alternative to free trafficking or to adding refundability to the present system would be to adopt refundability along with certain changes in the income tax system to minimize the disadvantages of refundability, such as an increase in the economic distortion resulting from tax preferences and the high revenue cost. These collateral changes would include: (1) redefinition of taxable income to conform more closely with the concept of economic income, (2) reduction of preference items, and (3) reduction of income tax rates. (These changes are similar to those contained in various "flat-rate" income tax proposals.) Without such changes, the accelerated depreciation and other preferences in the Code would result in the refunding of paper losses. Also, refundability may magnify the incentive to generate such paper losses.

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[7] For example: Sec. 162(a)(1) (imposing a "reasonable" limit on salaries that may be deducted; and Sec. 385 (which authorizes the IRS to promulgate regulations for classifying investments as debt or equity). See M. Campisano and Roberta Romano, "Recouping Losses: The Case for Full Loss Offsets," *Northwestern University Law Review*, Vol. 76, No. 5, (December 1981). pp. 709-744.

Rationalized anti-trafficking rules

A second option for change would be to retain the limited recoupment approach of present law but to tighten the anti-trafficking rules in order to eliminate tax-motivated mergers and acquisitions and to rationalize these rules by making the benefit of loss carryovers after a change in ownership equivalent to what the benefit would have been under a comparable set of facts. This objective is consistent with the limitations on partial liquidations in the Tax Equity and Fiscal Responsibility Act of 1982 and the restrictions on tax-exempt leasing adopted by the House Ways and Means Committee in July of this year (H.R. 3110). One way of achieving this objective would be to assume that when a corporation purchases the stock of a loss corporation, it is, in substance, purchasing the assets of that corporation. Under this logic, a corporation which purchases all the stock of a loss corporation should not be allowed to use any of the other corporation's losses, since no losses would have been available had the assets been purchased directly. Another way of achieving this objective would be to estimate how much benefit the loss corporation would have obtained from its losses had its ownership not changed and to limit its benefit from the sale of its losses to this amount. If this rule could be implemented precisely, losses would not be a factor in a decision by the loss corporation's shareholders to sell their stock, since a potential buyer would not be willing to pay more for the corporation's losses than the benefit the sellers could have realized if a sale did not take place. Consequently, acquisitions would be more likely to occur for reasons of economic efficiency rather than taxes. Of course, the success of such a rule is likely to depend on the accuracy of the assumptions made in deriving the estimate of what the benefit of losses would have been if a sale had not taken place; this depends on what taxable income would have been. The mechanics of such a rule have been developed by the ALI and further refined in the proposal developed in the last part of this pamphlet.

A disadvantage of retaining the limited recoupment approach is that it would not achieve a completely level playing field. Diversified and ongoing companies would still have an advantage, relative to start-up and loss companies, in undertaking risky investments and other activities which generate tax losses. Merger and diversification thus would still be encouraged in *anticipation* of the chance of future unutilized loss carryovers, although leasing, partnership agreements, etc. would still be available to transfer some tax benefits where tax losses were expected.

The primary advantage of rationalizing the limited recoupment approach are that it would reduce tax-motivated acquisitions without the revenue loss, increased tax preferences, and perception problems entailed by refundability or free trafficking. Also, there would be less incentive to operate uneconomic assets acquired from a loss company for the sole purpose of preserving the right to use loss carryovers.

IV. EVALUATION OF PRESENT LAW AND ALTERNATIVE APPROACHES

A. Problems With the Rules Adopted Under Present and Prior Law

The revisions of the limitations on NOL carryovers adopted in the 1976 Tax Reform Act have been widely criticized, primarily because of the complexity of those rules, and their effective date have been deferred three times. The defects in the limitations of present law (the 1954 rules) which the 1976 changes would correct make the advisability of continuing those rules questionable.

Problems with 1954 rules

The present rules are inadequate because the vagueness of the business continuation requirement of sec. 382(a) has produced much litigation without significantly clarifying the scope of the requirement. Further, the continuing business may be a relatively insignificant part of the surviving corporate enterprise and need not produce any of the income against which the carryovers are absorbed. Moreover, the requirement operates as an inducement to carry on a business with little or no likelihood of profitable operation solely to preserve NOLs.

The present rules also do not apply to certain types of transactions, such as acquisitions of stock for stock of the acquiring corporation, and also are ineffective with respect to certain acquisitions by subsidiaries for stock in the parent corporation. Further, the limitations applicable to stock acquisitions are not consistent with those applicable to asset acquisitions.

Problems with 1976 revisions

The 1976 revisions, in order to make the limitations operate more effectively, would eliminate the business continuation requirement, coordinate the treatment of stock acquisitions with the treatment of asset acquisitions, and cover the types of transactions that can be utilized to avoid the present law rules. However, those revised rules have been widely criticized as excessively complex and many commentators thought more stringent rules were not required.

Examples of operation of rules

Aside from technical problems and complexity, both present law and the 1976 revisions fail to impose restrictions on transactions that are tax motivated in some cases. NOLs would be disallowed in such cases only if the principal purpose for the acquisition of the loss company is tax avoidance (sec. 269). In other cases, limitations will be imposed where tax benefits are of little significance, principally under the 1976 revisions. These effects, aside from the possi-

ble application of section 269, can be illustrated by the following examples:

Example (1). L (a loss corporation) is merged into P (an acquiring corporation). L has net operating losses in excess of $22 million. The net value of L's other assets is $5 million. P's stock before the merger has a value of $15 million and its pre-tax income is $3 million a year. As a result of the merger, and assuming L's assets will produce $1 million of income, P's after-tax income increases from approximately $1.6 million to $4 million during the period that L's carryovers are available. L's shareholders receive P stock with a value of $10 million, which represents 40 percent of P's stock after the merger. Under the 1954 rules, no limitation applies under section 382 where L shareholders receive at least 20 percent of the stock of P. No limitation applies under the 1976 revision of section 382 as long as L shareholders receive at least a 40 percent stock interest. Thus, no limitation would apply under either set of rules although the transaction is tax motivated.

Example (2). L has net operating losses of $10 million and other assets with a net value of $50 million. L is merged into P, and L shareholders receive 20 percent of P stock. While no limitation would apply under present section 382, under the 1976 revisions, L's carryovers would be reduced by 70 percent (3.5 percent for each 1 percent by which the L shareholders interests fall below 40 percent). A limitation applies under the 1976 rules although tax benefits are a relatively small element in the transaction.

Example (3). L has no assets other than net operating loss carryovers of $20 million. P has pre-tax income of approximately $1 million a year and pays annual tax of approximately $460,000. L is merged into P with L shareholders receiving 20 percent of P's stock. The carryovers are reduced by 70 percent under the 1976 rules (to $6 million). The transaction is consummated because P believes that L's carryforwards will save it approximately $2.7 million in tax liability over the next 6 years. The present law section 382 rules would have no effect on this transaction.

These examples illustrate that the 1976 rules, criticized in part because of their harshness, do not preclude transactions that may be wholly or primarily tax motivated (Examples (1) and (3)), while penalizing other transactions where tax benefits are a minor consideration (Example (2)).

Another provision of present law affecting the use of NOL carryovers after a change of ownership is section 269. Under this section, if the principal purpose of acquiring a loss corporation is tax avoidance carryover benefits may be disallowed even though section 382 as currently effective or as revised in 1976 is inapplicable.

Tax avoidance is the principal purpose, in applying section 269, if it is more important than any other single purpose for the acquisition.[1] The deterrent effect of this provision in preventing tax motivated transactions is doubtful in many situations. Its ineffectiveness was a major reason for the adoption of section 382 in 1954.[2]

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[1] Treas. Reg. sec. 1.269-3.

[2] S. Rept. No. 1622, 83d Cong., 2d Sess., 52 (1954),

The uncertainty created by section 269 often results in heavy discounting the value of NOLs, thus reducing their benefit, the seller of a loss corporation, although the seller bore the economic burden of the losses.

B. Purpose of Limitations

In general

The problems with past and present rules are partly attributable to the absence of a coherent rationale for imposing limitations on carryover attributes after a substantial change in ownership of the corporation. A coherent limitation presumably would preclude a greater benefit from loss carryovers to be available to purchasers of a loss company than the loss company would have enjoyed in the absence of a change in ownership. The loss shareholders might have caused the corporation to dispose of its assets in liquidation or by selling them with the resulting corporate gain absorbing available carryovers. A limitation providing comparable results in a disposition of the loss company by stock sale or merger could be justified as a regime that minimizes the form chosen to effect a transfer. The ALI approach, on the other hand, would limit the benefit of carryovers by reference to a stream of income which, by hypothesis, the loss corporation would have produced to absorb its carryovers if there had been no change in ownership.

The objective of the ALI limitation would be to provide the same utilization, both in total amount and timing, of carryover benefits after a change in ownership as would have occurred in the absence of such change if the loss company continued its business. Under such a system, tax considerations would not induce the owners of a loss corporation to sell; nor would potential buyers seek a corporation with carryover benefits rather than one without such benefits.

The present or revised rules of section 382 do not always achieve the ALI objectives because, as illustrated, they accommodate transactions that may be wholly or primarily tax motivated, and the uncertainty caused by the primary purpose test of section 269 distort valuation of loss company stock the to the detriment of sellers.

H.R. 6295 proposal (97th Congress)

Under the approach included in H.R. 6295 (97th Cong.),[3] NOL carryovers would be allowed to the extent shareholders of the loss corporation, in the years the NOL arose, remain as shareholders in the carryover year. Since a loss corporation could always choose to sell its assets or to liquidate (*i.e.*, in such a case the NOLs could be used against gain realized on the sale or recapture income on liquidation, and, to that extent, would benefit the existing shareholders), a regime that is designed to reach results comparable to a sale of assets or a liquidation would minimize the significance of the form chosen to effect the transfer of a loss corporation's business. Also, such a system would prevent the loss corporation shares from being more valuable to a potential acquirer who could use the NOLs than the corporation would be to the existing shareholders upon liquidation or sale of the assets. Another advantage to this

[3] H.R. 6295 (97th Cong., 2d Sess.), as introduced on May 6, 1982.

approach is that it would be relatively mechanical, so there would be less pressure placed on valuing the shares of the loss corporation.

One problem with H.R. 6295 is that the bill failed to approximate the results of an asset sale or liquidation, in that no relief from the depreciation recapture rules was provided (even if the NOLs were produced by unused ACRS deductions that reduced asset basis). In order to provide relief from recapture, it might be appropriate to allow the loss corporation to step-up the basis of its assets, to the extent of the lesser of the amount subject to recapture or the NOLs disallowed as a result of ownership changes. Another problem with H.R. 6295 is that, like the 1976 revisions, it would reduce carryovers in transactions in which tax benefits are a relatively minor element in the transaction. Further, while the higher percentage of continuity of interest required by loss year shareholders under H.R. 6295 would make it unlikely that purely tax-motivated transactions would occur, its limitations may be perceived by some as overly restrictive.

Business continuity test

A strong argument can be made that a more stringent business continuation requirement than that contained in section 382 would not provide a practical limitation. Such a requirement was adopted by the Supreme Court for years prior to 1954 in the *Libson Shops* case. NOL carryovers, under that decision, could be deducted only against income from the same business that produced the losses. A major objection to this as the standard for controlling carryover benefits is the difficulty in defining a particular trade or business when business assets and activities are constantly combined, separated, or rearranged. It may also induce the continuation of a business that should be terminated because the taxpayer can anticipate untaxed income from that business compared with fully taxable income from a business change. Another objection, more conceptual, is that tax attributes such as NOL carryovers are attributes of the corporation incurring the loss and not of the activities in which they were incurred. Under this view, it is improper to consider the business operated by a corporation as an element of its identity and thus changes in its business should not affect the deductibility of its carryovers.

C. Purchase Price Limitation Proposals

The proposal of the Subchapter C Advisory Group appointed by the Ways and Means Committee is contained in its report dated December 11, 1958. This proposal would have limited carryovers to 50 percent of the purchase price paid for a corporation with NOL carryovers. Under such a limitation, tax considerations by necessity would be a minor element of the transaction. This conclusion derives from the fact that, even at a 50-percent tax rate, somewhat more than 75 percent of the price would have to be paid for assets other than tax benefits. The proposal would have imposed no limitation on the timing of carryover deductions following a change in ownership, however, and an NOL carryover could therefore result in greater benefit to an acquiring corporation with enough income

to absorb it immediately than it would have provided to the loss corporation in the absence of a change in ownership. This advantage would be particularly significant in the case of carryovers close to expiration, which the loss corporation might not be able to absorb.

More recently, a suggestion has been made to provide a limitation on carryovers equal to the full purchase price paid for a loss corporation.[4] Under this proposal, the price would be reduced by the cash and investment assets held by the loss corporation and there would be a requirement to retain the loss company's business assets following the acquisition. These modifications deal with efforts to inflate the price, and thus the allowable carryovers, by contributions of cash or investment assets in anticipation of the transfer, and also reflect the conclusion that an ongoing business enterprise is an essential element of the corporate identity to which the carryovers are attributed. This proposal, like that of the 1958 Advisory Group, imposes no limitation on the timing of carryover benefits which would result, in some cases, in greater and more rapid utilization of carryovers than the loss corporation would have enjoyed in the absence of a change in ownership.[5]

D. The ALI Proposal

The proposal developed by the ALI is designed to provide comparable treatment between a loss corporation which, without a change in ownership, continues to operate its business and one which changes hands by merger or a sale of its stock.[6] Under this proposal, when a loss corporation is a party to a merger or other corporate combination, income derived from that portion of the combined capital of the surviving entity that represents the percentage contributed by the loss company would be permitted to absorb the pre-merger losses of the loss company. A similar limitation would apply under certain circumstances if, instead of a

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[4] Bacon and Tomasulo, *Net Operating Loss and Credit Carryovers: The Search for Corporate Identity. Tax Notes,* September 12, 1983, p. 835.

[5] This rule is justified on the basis that the purchase price, properly adjusted, equals the present value of a stream of after-tax income on the purchase price which is of infinite duration. For a corporation with sufficient loss carryovers to absorb its anticipated income indefinitely, however, its after-tax income and pre-tax income will be the same for, at most, 15 years, the maximum carryforward period. If one then treats 15 years as if it were infinity and assumes that all income of the loss company for that period will be exempted from tax by the carryovers, one could equate the purchase price limitation with an income limitation, as the authors of the proposal do. However, assuming a loss corporation with a value (aside from carryover benefits) of $1,000 and a pre-tax return of 20 percent, the assets will produce an infinite stream of income of $200 per year. If one assumes carryovers to shelter the income for 15 years, one would value the corporation by adding to the $1,000 of "hard assets", the present value of the benefit of $200 of deductions for 15 years. The present value is calculated by using an after-tax discount rate which, for a 46-percent taxpayer, is 10.8 percent. The present value of the deductions would be $1,454 and the present value of the tax benefit (46% of $1,454) would be $669. Under these assumptions, assuming rules which limit the prevent value of tax benefits to $669 after a change in ownership, a purchaser would pay at most $1,669. Under the purchase price limitation, however, a purchaser might be willing to pay $1,850 ($1,000 for "hard assets" and tax savings of $850 attributable to a currently available deduction of $1,850 at a 46-percent tax rate). Further, the purchase price limitation makes available to a purchaser able to use them not only fresh losses but older losses that would expire unused in the absence of a change in ownership. The greater ability of the purchaser to absorb carryovers is inconsistent with the goal of neutrality of tax considerations in deciding whether to retain or sell a loss corporation. In general, the proposal described in the next session would limit the allowed annual loss in this example to approximately $200, computed by multiplying the purchase price by an assumed after-tax rate of return.

[6] American Law Institute, Federal Income Tax Project, Subchapter C, pp. 198-301 (1982).

merger, the income-producing assets of a loss corporation are increased by capital contributions after a net operating loss was incurred. Since, theoretically, a loss corporation's ability to produce income is not affected by a mere sale and purchase of its outstanding stock when its capital and business are unaffected, arguably the goal of neutrality does not require a limitation. However, in recognition of the opportunities available to new owners to provide the loss corporation with contributions that may be difficult to detect or measure (including new assets, greater efficiency, or more expert management or other services), the proposal would, after certain changes in ownership, require that the corporation's losses be absorbed at the same rate as if the income following the stock purchase equalled an objective rate of return on the purchase price.

A detailed explanation of a proposal similar to that developed by the American Law Institute follows.

V. EXPLANATION OF PROPOSAL

A. Overview

As indicated above, the proposal is primarily intended to permit a loss corporation, in the hands of new owners, to use its NOL carryovers approximately to the same extent, as to both amount and timing, as it could have used them had there been no change in ownership and had it invested its assets in activities generating income that would otherwise have been taxable. Implementation of the proposal would require the adoption of several simplifying assumptions. The proposal contemplates two general rules. The first, the purchase rule, would apply in cases in which outstanding stock of the loss corporation changes hands and in redemptions. The second, the merger rule, would apply in cases in which the loss corporation's assets are combined with the assets of a profitable corporation in a tax-free reorganization. The merger rule would also apply in cases in which the loss corporation issues new stock in exchange for cash or other property. Each general rule would have its own set of specific rules.

B. The Purchase Rule

Changes of ownership of outstanding stock

In any case in which outstanding participating (e.g., common) stock of the loss corporation changes hands in a sale or exchange after a loss year with the loss corporation remaining in existence, the purchase rule would limit the deduction of NOL carryovers from the loss year, as to both amount and timing, to what the loss corporation could have deducted had no change of ownership occurred and had the loss corporation begun to earn taxable income at an assumed rate of return on the assets owned by it at the time of the change in ownership. This limitation, together with the new stock issue rule discussed below, would prevent the new owners from putting new capital or income-generating opportunities into the loss corporation so as to enable the loss corporation to obtain greater utilization of its NOL carryovers than it could have had there been no ownership change or capital infusion. Because NOLs allowed annually would be a percentage of the purchase price, no loss corporation would be acquired solely for its NOLs.

While the purchase rule tends to make arbitrary assumptions about the future of the loss corporation and its assets, that is a necessary consequence of any objective standard that might be adopted.

Specifically, for each taxable year of the loss corporation ending after the change in ownership, the deduction of NOL carryovers otherwise available would be limited to an amount up to the assumed rate of return times the price at which its participating

stock had changed hands (or the fair market value of the consideration received by those disposing of such stock). If less than all the stock of the loss corporation changes hands, income attributable to the stock as to which no change in ownership had occurred could absorb carryover deductions without limitation. To the extent the limitation for any taxable year exceeds the income for that year, the excess would increase the limitation in the following taxable year. The assumed rate of return would be an after-tax rate of return.

Example (1).—All the participating stock of a loss corporation is sold by A to B for $100,000. The loss corporation has a $50,000 loss carryover from the taxable year prior to the sale. It earns $12,000 of taxable income in the first taxable year after the sale and $5,000 in the second. The assumed rate of return is 10%. A loss carryover deduction of $10,000 would be allowed for the first taxable year after the sale, and a deduction of $5,000 would be allowed for the second. $35,000 in loss carryover would be available for later years, $15,000 of which could be deducted in the third taxable year after the sale assuming sufficient taxable income.

Example (2).—A owns 40 percent of the stock of a loss corporation, and B owns 60 percent. The loss corporation has a $50,000 loss carryover. C buys B's stock for $60,000, and the corporation has taxable income of $12,000 in the first taxable year after the purchase. The assumed rate of return is 10%. A loss carryover deduction of $10,800 (40 percent of $12,000 plus 10% of $60,000) would be allowed for the first taxable year after the purchase.

The rate of return

Whatever rate of return is set would tend to be arbitrary. In theory, the objective would be to determine what the loss corporation's future taxable income would have been had no sale occurred or capital been infused. It is clear, however, that if the rate of return is applied against the purchase price, as proposed, it must be an after-tax, not a pre-tax, rate of return. This is because under the proposal, the purchase price would cover both "true" asset value and value attributable to the NOLs, while only the true assets would generate future income.

For example, suppose a loss corporation has true assets worth $540 and an NOL of $2,000. The true assets will generate pre-tax income at a 20-percent rate a year, or $108 a year. All the stock is sold for $1,000 (see below). If the purchase rule used a pre-tax rate of return, NOL deductions of $200 per year would be allowed, more than the loss corporation could have used had no change in ownership occurred or capital been infused. If an after-tax rate of return is used (assuming a 46-percent tax rate), NOL deductions of 10.8 percent of $1,000, or $108, would be allowed every year. This is exactly what the loss corporation could have used under the assumptions stated. And, under this rule, $1,000 would be the approximate amount a purchasing corporation would be willing to pay—the sum of the $540 value of the asset and the approximate $460 present value of the $108 annual stream of NOLs, valued using the after-tax rate of 10.8 percent.

There are a number of factors complicating the choice of the rate of return. Some factors suggest a higher rather than lower figure.

For example, in the preceding example the buyer may be using a sufficiently high discount rate that he would not pay $460 for the NOLs. Or there may have been only, say, $200 in NOLs rather than $2,000. Finally, whatever rate of return is used would need to be based on an assumption in regarding distribution or retention of earnings. Other factors suggest selecting a lower figure. For example, the assumption that the loss corporation would make *any* income in the future may be very generous. Furthermore, to the extent the loss corporation's assets are depreciable, the resulting depreciation deductions would have reduced its future taxable income, and hence, its ability to use its own NOLs.

In any event, the rate of return should be set so as to be neither no more nor less generous than what would be provided under the merger rules (see below).

Built-in losses, built-in gains

Special problems are created by loss corporations having built-in gains (value of assets exceeds their adjusted basis) or built-in losses (adjusted basis of assets exceeds their value) at the time of the ownership change. These would have increased or decreased the ability of a loss corporation to use its NOLs if it had stayed independent.

Absent a special rule, built-in losses would be recognized under general Code principles. But that approach would permit a loss corporation, after its stock was sold, to reduce or eliminate the impact of the purchase rule's limitation by recognizing its built-in losses after the change in ownership (and investing the proceeds in assets performing functions similar to those performed by the assets sold).

For example, a loss corporation has true assets worth $1,000,000 with an adjusted basis of $1,500,000 and a net operating loss carryover of $500,000. All its stock is sold for $1,600,000. The year after the sale it recognizes the $500,000 built-in loss, investing the proceeds in the same kind of property as that sold, and has other taxable income of $500,000. Absent a special rule, taxable income for the year would be zero. This is far in excess of the benefit the corporation could have achieved from the loss had ownership not changed. If the built-in loss had not been recognized, the loss corporation would have been allowed a loss carryover of $50,000 (with a 10 percent assumed rate of return), leaving taxable income of $450,000. One solution to this problem would be to adjust NOL carryovers upward for built-in losses and not permit such losses to be recognized again. However, this solution would also create a problem in that loss carryovers would be created prematurely.

As for built-in gains, they will often be a product of special tax rules either accelerating deductions or deferring income. ACRS deductions and installment sales reporting are two prime examples—in each case, basis will generally be less than value. Absent a special NOL rule, if built-in gains are recognized after a change of ownership they would be fully subject to the purchase rule limitations even though, had no change of ownership occurred, NOLs would have been available to fully offset the resulting income. If ACRS deductions generated by particular assets gave rise to the NOLs, it might be inappropriate not to permit those NOLs to offset recapture income generated by a sale of those assets. On the other hand, permitting NOLs to offset recognized built-in gains without

limitation would also create a problem. In such a case, a loss corporation could recognize its built-in gains and invest the sales proceeds in new property of the same kind. Since the new property would be eligible for ACRS deductions, the loss corporation could minimize the effect of the purchase rule. It would in effect have traded NOLs subject to a limitation for current tax deductions not so limited.

The purchase rule would not apply unless more than 50 percent of the outstanding participating stock, by fair market value, of the loss corporation changes ownership after a loss year. This rule reflects an assumption that a buyer will not make covert (and hence uncompensated) capital infusions to a loss corporation unless he becomes at least a 50 percent shareholder. For administrative convenience, to determine whether the threshold was satisfied, only ownership by persons owning, directly or by attribution, 5 percent or more of such stock in the carryover year would be looked at. Furthermore, a shareholder in the loss year could increase his percentage interest by 50 percent (e.g., from 20 percent to 30 percent) without the purchase rule applying to such increase, except to determine whether more than 50 percent of the outstanding participating stock, by fair market value, changed hands. This rule is based on the notion that some change in ownership of a loss corporation among existing shareholders should be tolerated without imposing NOL limitations, even if an existing minority shareholder takes control.

Redemptions

In the case of redemptions, which can give rise to substantial changes in percentage ownership, the purchase rule would also be applied.

Example (3).—A owns 20 percent and B owns 80 percent of the stock of a loss corporation worth $100,000. All of B's stock is redeemed for $80,000. Since A now owns more than 150 percent of the percentage of the participating outstanding stock he did before the redemption, and since more that 50 percent of the outstanding participating stock, by value, changed hands, the purchase rule would apply, but it would not be applied to the extent A's interest increased from 20 to 30 percent. The annual limitation would be 30 percent of taxable income plus the assumed rate of return times $14,000, determined as follows: since 80 percent of the stock was redeemed, the limitation would be based on only 20 percent of the purchase price taken into account. The purchase price is $70,000 ($10,000 is excluded from the purchase price since that portion increased A's original 20 percent interest by 50 percent); 20 percent of $70,000 is $14,000.

The purchase rule necessarily would apply as well to changes in ownership attributable to both purchases and redemptions.

Example (4).—A owns 20 percent and B owns 80 percent of the stock of a loss corporation worth $100,000. A buys an additional 40 percent from B (one-half of B's stock) for $40,000. B's remaining 40 percent interest is redeemed 2 years thereafter for $40,000. A limitation applies following the redemption since A's interest has increased from 20 percent to 100 percent. The annual limitation is 30 percent of taxable income (attributable to 150 of A's original 20

percent interest) plus the assumed rate of return on $42,000, determined as follows: since 40 percent of the stock of the corporation was redeemed, the limitation would be based on only 60 percent of the purchase price taken into account. The purchase price taken into account is $70,000, i.e., $30,000 of the $40,000 paid by A to purchase a 40 percent interest from B ($10,000 is excluded from the purchase price since that portion increased A's original 20 percent interest by 50 percent) plus the $40,000 paid to redeem B's remaining 40 percent interest.

C. The Merger Rule

Acquisitions of loss corporations

In any case in which the assets of loss corporation are combined with those of a profitable corporation in a tax-free reorganization, loss carryovers otherwise available would be allowed to offset post-acquisition income of the acquiring corporation allocable to the contribution of the loss corporation's assets to the acquiring corporation's income. The merger rule is intended to provide for the allowability of the carryovers roughly to the same extent they would have been allowed if the loss corporation and the acquiring corporation had each contributed their assets to a partnership. In such a case, of course, only the loss corporation's share of the partnership's income could be offset by the loss corporation's carryovers. The purchase rule is not applied in such a case because the purchase rule makes perhaps arbitrary assumptions about how the loss corporation's assets will be deployed. In a case of this type, no such assumption need be made—the loss corporation has invested in its merger partner.

In a reorganization of the type described, the portion of the post-acquisition income of the acquiring corporation allocable to the loss corporation's assets would be determined with reference to the percentage of participating stock of the acquiring corporation issued in the acquisition. However, the percentage of income that could be offset would be less than the percentage of participating stock of the acquiring corporation issued to the loss corporation (or its shareholders) in the acquisition. The reduction is designed to adjust for the fact that to the extent of allowable carryovers, income allocable to the loss corporation's assets would not be subject to tax. Therefore, the percentage of participating stock which would be issued in the acquisition would generally exceed the percentage of pre-tax income of the acquiring corporation allocable to the loss corporation's assets. The percentage of income that could be offset would be determined by a statutory table keyed to the percentage of the participating stock of the acquiring corporation issued in the acquisition. For example, if the acquiring corporation issues 10 percent of its participating stock, the percentage of post-acquisition income that could be offset in any one taxable year would be 5 percent. If it issues 50 percent, the percentage would be 35 percent.

The table, derived from the ALI proposal, would be as follows:

Participating stock issued to loss corporation (or its shareholders)	*Pre-tax income that may offset*
More than 0 percent but less than 20 percent	0 plus .5 percentage points for each percentage point over 0 percent.
More than 20 percent but less than 40 percent	10 percent plus .75 percentage points for each percentage point over 20 percent.
More than 40 percent but less than 60 percent	25 percent plus 1 percentage point for each percentage point over 40 percent
More than 60 percent but less than 80 percent	45 percent plus 1.25 percentage points for each percentage point over 60 percent
More than 80 percent	70 percent plus 1.5 percentage points for each percentage point over 80 percent

Example (5).—A loss corporation merges into a profitable corporation in a section 368(a)(1)(A) merger reorganization. The loss corporation's shareholders receive 25 percent of the profitable corporation's common stock, its only class of stock outstanding. Loss carryovers otherwise available under section 381 would be allowed to offset (under the table) 13.75 percent of the acquiring corporation's income each taxable year after the acquisition, subject to the provisions of section 381(c)(1).

If the acquiring corporation issues stock and other property in the reorganization, both the purchase rule and the merger rule would apply.

Example (6).—The facts are the same as in Example 5 but the acquiring corporation pays out $100,000 in cash as well as 25 percent of its common stock. The assumed rate of return is 10 percent. In the first full taxable year after the acquisition, the acquiring corporation has taxable income of $200,000. Loss carryovers otherwise available would be allowed for that year up to $36,125 (10 percent of $100,000 plus 13.75 percent of $190,000). If the acquiring corporation has no taxable income in that first full year but $200,000 in its next taxable year, loss carryovers otherwise available would be allowed in the latter year in the amount of $44,750 (20 percent of $100,000 plus 13.75 percent of $180,000).

If the acquiring corporation issues only preferred stock with a market rate yield, the loss carryover otherwise available would in no year be allowed in an amount exceeding an amount of income of the acquiring corporation equal to the dividends paid or accrued on the preferred stock issued in the acquisition, together with any excess limitations from prior years. If the acquiring corporation already has preferred stock outstanding, its post-acquisition income to which the merger rule would apply would be reduced by the dividends paid or accrued on the preferred stock already outstanding divided by 1 minus the maximum statutory corporate tax rate. This "gross-up" would reflect the fact that the acquiring corpora-

tion would be taxed on amounts it pays out as dividends on such preferred stock.

Example (7).—The facts are the same as in Example 5 but the acquiring corporation has $100,000 of 10 percent preferred stock already outstanding. Loss carryovers otherwise available would be allowed to the extent of 13.75 of the acquiring corporation's income after subtracting therefrom the amount of $18,516 ($10,000 divided by (1–.46)).

A limitation would be applied in every case in which a loss corporation is acquired in a reorganization of the type described, regardless of the relative sizes of the acquiring corporation and the loss corporation. Special rules would be provided defining participating stock and preferred stock and covering convertible instruments, options, and warrants, etc. In general, both the purchase rule and the merger rule would be applied with respect to convertible debt or stock, options, warrants. etc., and the limitation allowing the smaller loss carryover deduction would be the one used. Special provisions would also be made for preferred stock with excessive dividend or early redemption provisions.

New stock issues

No limitation would apply if new stock is issued for cash or other property by a loss corporation pro rata to loss year shareholders. Furthermore, as under the purchase rule, no limitation would apply if no loss year shareholder increases his interest in the fair market value of the participating stock of the loss corporation by more than 50 percent (e.g., from 20 percent to 30 percent) from the loss year. These rules recognize that, within limits, a loss corporation should be free to attempt to rehabilitate itself. However, if new shares are issued to a loss year shareholder and such shareholder subsequently sells those shares (or other shares carrying the same percentage interest) or the loss corporation is acquired in a reorganization of the type described, the new shares would be treated as having been issued directly to the buyer, or, after the reorganization, to the acquiring corporation.

Example (8).—A, B, and C are equal shareholders of a loss corporation worth $300,000. A contributes $100,000 of capital to the loss corporation in exchange for newly issued stock with the result that A's percentage interest increases from one-third to one-half ($200,000 out of $400,000). Since A's interest did not increase by 50 percent or more, no limitation would apply. If A subsequently sold his new shares to D, they would be treated as having been issued to the buyer and a limitation (see below) would apply.

If a loss corporation issues new participating stock to third parties, the merger rule would apply by looking at the percentage interest in the loss corporation's participating stock remaining with loss year shareholders. If a loss corporation issues new preferred stock to third parties, income which could be offset by loss carryovers otherwise available would be reduced by the total grossed-up yield on such preferred stock.

Example (9).—The facts are the same as in Example 8 but the $100,000 in new stock is issued to D, not A. Since loss year shareholders retained 75 percent interest, loss carryovers otherwise

available after the new issue could offset 63.75 percent (from the table) of the loss corporation's income every taxable year.

Example (10).—A owns all the common stock of a loss corporation worth $100,000. The loss corporation, which has a loss carryover of $25,000, issues $50,000 in new 12 percent preferred stock to B. The grossed-up dividends payable to B reduce the taxable income eligible to absorb the carryover. In the year after the new issue, the loss corporation has $20,000 of taxable income. A loss carryover deduction of $8,889 ($20,000 minus $11,111, i.e., $6,000 divided by (1-.46)) would be allowed.

However, no new issue limitation would apply if the loss corporation issues for cash or other property in any one calendar year new shares (including preferred shares) worth less than 20 percent of all the loss corporation's shares at the beginning of the year. If the 20 percent threshold is exceeded, the limitation would be applied with respect to the entire new issue, not just the excess.

Certain changes in ownership attributable to a combination of new issues and redemptions (or redemptions and new issues) would be treated as purchases, and the purchase rule would apply. The purchase price would be the price at which the the earlier to occur of the redemption, or new issue was carried out.

Example (11).—A and B each own 50 percent of a loss corporation worth $100,000. A contributes $50,000 in capital to the loss corporation for new issue shares. Six months later, B shares are redeemed for $60,000. A would be treated as buying B's shares for $50,000. However, since only a 50 percent ownership change had occurred, no limitation would apply.

In the case of changes in ownership attributable to both new issues and purchases, both the purchase rule and the merger rule would apply.

Example (12).—A owns 10 shares of a loss corporation worth $100,000 and with a $50,000 loss carryover, and B owns 90 shares. A buys 70 shares from B for $70,000 and, two years later, contributes $50,000 to the loss corporation for 50 new shares. Since, by reason of the purchase, ownership of more than 50 percent of the loss corporation's participating stock has changed hands, a purchase rule limitation would apply after the purchase. In the first taxable year after the purchase, the limitation would be 35 percent of income (15 percent attributable to A and 20 percent to B) plus the assumed rate of return, say 10 percent, times $65,000. In the first taxable year after the new issue, both the purchase rule and the merger rule would apply. Suppose taxable income for that year is $20,000. Loss carryovers otherwise available would be allowed in the amount of $10,175, determined as follows. Since the new issue resulted in one-third more shares, the table would allow 52.5 percent of the $20,000. (Since A's increase in percentage interest resulting from the purchase was ignored to the extent it did not exceed 50 percent, no increase in his interest resulting from the new issue would be ignored in applying the merger rule.) 52.5 percent of $20,000 is $10,500. The limitation from the purchase rule would then be applied to the $10,500. 35 percent of $10,500 plus 10 percent of $65,000 is $10,175.

D. General Rules

Creditors exchanging debt claims for stock would be treated as having received shares in a new issue. However, stock received for debt that was held by creditors in the loss year would be treated as stock outstanding in the loss year. This latter rule reflects the fact that the loan capital was a part of the loss corporation's capital during the loss year and that an interest deduction is being surrendered.

Reorganization transactions in which the loss corporation becomes a subsidiary of the corporation, the stock of which is issued in the acquisition, would be subject to the purchase rule and not the merger rule. However, no threshold would be applicable. Since the loss corporation remains a separate entity, use of the merger rule would seem inappropriate. The merger rule is more suitable when the loss corporation and a profitable corporation combine in a single entity.

In general, the SRLY rule (particularly in a purchase rule case), including the reverse acquisition rule, and the CRCO rule under the consolidated return regulations would remain applicable, as would section 381. But neither section 269 nor *Libson Shops* would any longer apply to disallow loss carryovers.

No limitation would apply in the case of any reorganization transaction in which both the loss corporation and the acquiring corporation are owned by the same persons in substantially the same proportions.

Rules paralleling the foregoing, to the extent possible, would be provided for capital loss carryovers and credit carryovers.

E. Passive Assets

Some loss corporations may divest themselves of some or all of their operating assets and invest the proceeds in passive investment assets. They may or may not be anticipating a change in ownership. Should those corporations be permitted to pass loss carryovers on to acquiring corporations (or be permitted to retain such carryovers in the event of a change of ownership)? Section 269, under present law, would almost certainly be applied to disallow the NOLs.

To the extent the NOLs would survive, the stock of loss corporations with large loss carryovers and true assets consisting of only, say, $100,000 in Treasury bills would be worth more than $100,000. While any loss corporation would be worth more than the value of its true assets if the basic proposal is adopted, there may be reason to distinguish the case of a loss corporation holding mainly passive assets from the case of a loss corporation operating an active business and holding few if any passive assets. For example, under present law, the personal holding company rules (sec. 541 *et seq.*) and the accumulated earnings tax rules (sec. 531 *et seq.*) make it difficult for many corporations to sell their business assets and invest tax proceeds in passive assets as a way to use up to NOLs. Furthermore, if the loss corporation sells its business assets and invests passively prior to being sold, neither the shareholders nor the business of the loss corporation would be the same as when the loss was incurred. Perhaps NOLs following a change of ownership

should be disallowed if more than a specified percentage of the loss corporation's assets are passive in character.

F. Effective Date

The proposal would be effective for all mergers and purchases on or after January 1, 1984.

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